The MORTGAGE BANKER

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The Dangers of Inflationary Costs Warn Lenders to "Keep Behind the Market"

This lender sees a recurrence of old problems if we freely reflect in our appraisals the higher building costs

By **T. S. BURNETT**

RECAPTURE of money let out to hire, plus interest for its wage, depends on securing and maintaining a safe margin of equity between the amount of the loan and a fluctuating market value of the security.

Most manufacturing processes produce by-products. *Ours* is real estate acquired by foreclosure. Restriction of losses through the resale of real estate is our objective; and our success with it depends on a sound average ratio of loan to value over a period of years so that, at no time, will an unduly large percentage of borrowers be without a substantial and attractive equity.

Allowance must now be made for the extent to which actual building costs are the result of abnormal factors resulting from the present emergency, as contrasted to costs which would have resulted from a natural cycle of supply and demand. Both the temporary and the long-term effect of forces at work must have our attention.

Temporarily it appears that: *All elasticity is out of construction costs at present prices and they will continue upward.*

Defense priorities will tend to hold down the total volume of building and divert it to defense areas where the influx of population is great. This may result in a shortage of housing in all areas with the accent on small homes sold on a basis of little or no equity investment. Other houses will show abnormal costs due to priority discrimination and the number of families who can afford to own such homes will diminish through increased living costs and taxes.

FROM all we have been able to read and hear, the opinions set forth here ought to win unanimous approval. Mr. Burnett declares that these are highly abnormal times and that goes for building costs too. Thus we must not mistake price for value; it is a time for careful procedure. He thinks, too, that there is added danger in the fact that no one can foresee very clearly what conditions will exist after the emergency—and that this alone is ample reason for a highly cautious attitude in reflecting increased building costs in appraisals.

Higher rents and building costs will necessitate higher wages, which, in turn, (due to the inflationary cycle) will result in still higher rents and costs.

There is danger, therefore, of a definitely inflationary cost of building. It, in my opinion, behooves lenders to keep a respectful distance behind the market. *The danger point in building costs probably has not yet been reached,* but they will rise so rapidly that the danger point will come unnoticed and will be passed with a rush. If mortgage lenders go with the tide it will only contribute to the current march toward inflation and the erection of a "House of Cards."

It is the permanent and long term effects of this whole problem that should really arrest our attention.

We should be careful about drawing inferences from the last war. The stage is set differently today. Government spending for defense will have a more complicated effect and will not necessarily bring increased profits. This is due to excessive labor costs and the deflationary effect of controlled economic policies, regulations, price fixing, taxes and priorities.

Construction costs are relative and have considerable geographical variation. Because of this fact, they must be dealt with in generalities. All MBA members know what they are today in their communities. They have a good idea of what a fair and representative cost has been over a period of years, and how this

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What should be the relationship between institutional investors and their correspondents?

AS AN INSTITUTIONAL INVESTOR SEES IT

***By* WM. B. F. HALL**

EXCEPT that it must be based upon permanence, intimate understanding, and mutual respect, there can be no general formula exactly expressing the inherent relationship between all correspondents and all of the institutional investors they represent. The term *correspondent* is too broad and too incapable of exact definition, and the range of correspondent activities is entirely too great to make any such generalization. However, it would seem almost impossible to overestimate the value and importance of each individual correspondent determining for himself, and with his principal, the exact nature of that particular inherent relationship that exists between them. Correspondent and principal must work together as a team; and unless there is a complete understanding between them of the exact nature of the relationship that binds them together, this team will most certainly suffer dissolution or defeat. My thoughts here are devoted more to the analysis of the individual relationship that exists between a particular correspondent and his particular institutional investor rather than any attempt at a generalization of the entire field.

By way of description rather than an attempt at definition, it would appear that the mortgage loan correspondent is the best possible combination between an entirely independent operator and a direct employee of an institutional investor. If this were not true, the correspondent system, instead of handling a vast majority of all institutional mortgage investments, would fold up, and the mortgage business would flow only through broker and branch office channels. There is no better known way to get and service mortgage loans than through the correspondent system.

This, then, is the basic formula for analyzing your particular relationship with your own particular principal or principals. If you accept it, you must then say to yourself: "If this team is to function successfully, I must, insofar as I possibly can, give to my principal every possible advantage that would accrue to him if I were his salaried employee, but relieve him of the inherent disadvantages of the branch office system; and by a like token, I must protect my principal against all of the inherent disadvantages he would encounter in acquiring new mortgage business through individual or irresponsible one-case mortgage brokers."

THIS article, and its companion piece by Mr. Scott beginning on the following page, represents a type of discussion we would like to see more of in the pages of The Mortgage Banker. MBA has many institutional investors among its members and a majority of our city mortgage men represent one or more institutional investors. There is no other publication so well suited to serve as a forum for an exchange of views on the important problems affecting both correspondent and investor. We hope these articles inspire similar contributions from others.

Under this same formula, the other member of the team must say to himself: "Insofar as it is possible, I must make available to my correspondent all of the advantages — promptness, permanence, and prestige due to a direct salaried representative—and yet I must never fail to recognize that it is the independent nature of this correspondent's business that enables him to deliver me more useful services per dollar than is possible in any other way."

It is obvious that in applying this formula, each individual team of correspondent and principal must sit down together and decide for themselves just what proportion of *direct representation* and of *independent operation* will produce the best mixture to run their own particular business machine. For instance, certain correspondents have an extremely high content of "independent operator". Except that they collect and remit servicing items, they approach a straight mortgage brokerage operation. They prefer to have connections with more lenders than they can hope to provide loans for and tend to change quickly and often from one to another in order to sell their loans to the very best possible advantage with each short-term change of the mortgage market.

In this there is nothing inherently reprehensible, and there are undoubtedly many correspondent-lender connections where such a procedure works out for the best interest of all parties concerned. However, this correspondent, having once determined upon a high independent operator content, cannot in fairness expect to receive from his principal the same consideration which a direct representative type of correspondent will receive *when the money market changes,* or *when there is a question of apportionment of available funds,* or *where the matter of exclusive territory arises.*

On the other hand, there is the type of correspondent operation that has a very high "direct representation content" in the business mixture. Such a correspondent may confine his entire efforts to making and servicing loans for one principal, and for this principal he performs services of great trust and responsibility. He makes loans of a kind and in locations as specified by his investor, and the terms of sale and servicing are relatively stable. Although he is paid upon a commission basis, he knows that over a period of years his total compensation will be dependent entirely upon the long-term profit of his operation to his principal; that, as in the case of a salaried employee, his success or failure will not

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What should be the relationship between institutional investors and their correspondents?

AS A CORRESPONDENT SEES IT

By JOHN H. SCOTT

I don't know whether the Greeks had a word for it, but the Romans did, for the Latin phrase *uberrimae fidei* (of the very greatest faith) accurately describes what the relationship between a correspondent and an institutional lender should be. Having resorted to the Latin for this descriptive phrase, let me do so again for the sake of contrast. If *uberrimae fidei* correctly describes the basis of the relationship, certainly the words *caveat emptor* describe the opposite of such a relationship. By not pertaining in any sense to it, it emphasizes the positive nature of a relationship of the very greatest faith.

What, exactly, do we mean by the words *of the greatest faith?* I can best convey the meaning as I see it by contrasting them with other ordinary relationships.

People of honor engaged in business dealings with one another are required to behave with reasonable honesty. The law sets up certain standards below which no one is allowed to go; the conventions of business life, or the climate of opinion in which we exist in our day and age, set up another and perhaps somewhat higher standard.

Both these standards of business conduct are derived, of course, from Christian ethics under which all of us exist, regardless of creed or denomination. I think these standards can best be described as those which, while requiring a decent and honest attitude, include in their premises the thought that the dealings are at arms length, and do not postulate a fiduciary standard.

A relationship *of the very greatest faith,* however, is based upon the premise of a fiduciary standard, which is mutual, and which must at all times, under all circumstances, be conscientiously adhered to by both parties. Obviously, mutuality of conduct is essential, since if one party adopts such a premise while the other deals at arms length, the relationship will soon cease.

Well, this is all very fine from an abstract viewpoint, but what does it mean in terms of daily business routine?

For the *correspondent,* it means:

1. A meticulous care in the presentation of all relevant facts to the principal, including favorable facts, adverse facts, and relevant facts, if any, not included upon the face of the application.

2. It means an habitual and deliberate separation of the facts from opinion or judgment. I do not think it necessary to elaborate in detail upon this phase of a correspondent's activity. You know what I mean by a segregation of facts from opinion. If I seem to stress the idea, it is simply because, in the presentation of any particular case, it is very human to mix facts with opinion. I think it is a weak and bad practice. It will inevitably put the correspondent in the position of having to "justify" something he has done. For his sake, as well as that of his principal, he should avoid that position. Let the facts speak for themselves; and let his opinion based on the facts, stand or fall upon its strength, or weakness; but do not, in any event, allow the principal, by reason of the intermingling of facts and conclusions, mistake one for the other. If trouble follows, the lender will justifiably criticize the correspondent. Fundamentally he is entitled to a clear presentation of the case.

MR. Hall is manager of the mortgage loan department of The Lincoln National Life Insurance Company of Ft. Wayne and Mr. Scott is president of The Scott Mortgage Company of Pittsburgh. One of the significant features of Mr. Hall's article is his discussion of the advantages of the correspondent system — "there is no better known way to get and service mortgage loans than through the correspondent system" Mr. Scott's contribution is largely devoted to the rights, duties and obligations of both correspondent and investor under the system.

3. It means a careful and continual inculcation of the idea of a fiduciary standard into your personnel. This is not so easily done as said. Mortgage solicitors work in the field, always in the face of stern competition. Sometimes, as in recent months, the competition accomplishes the absurd in terms of amount, interest, and renumeration. Individual cases will create situations when the loss of the application, perhaps after months of preparatory effort, lead the individual to doubt the advisability of adherence to a preconceived standard. The solicitor is out of pocket, the correspondent is out of pocket, the competition is laughing at you.

This is where morale counts. In the long run, sticking to your beliefs, if those beliefs are fundamentally sound, will be profitable to you, and will keep you in business when the fly-by-nights have been long since forgotten. Preach this doctrine to your men; it will prove itself; and once it has been proved your field troubles diminish. The men will learn through experience that fiduciary is a word of definite asset value.

4. Bring as many of your personnel, and certainly your department heads, into contact with the corresponding home office men as possible. Let them learn to know one another; let mutual criticism and discussion have a free hand; and, if such course does not eventually produce a mutual confidence not otherwise to be obtained, you may be certain that either you or the home office has the wrong man.

5. It is the obligation of the correspondent to stand as a buffer between

his principal and the public. It is inevitable both in the process of originating and in the subsequent servicing of loans that misunderstandings will arise between borrower and lender. Every effort should be extended to keep these from becoming acrimonious. But, in any event, it is the duty of the correspondent to assume the burden of adjusting differences, which must be accomplished in such a way as to avoid blame and censure of the principal. The lending institution is usually engaged in a business in which the public relations feature is very important. The correspondent should *never* lose sight of this fact.

CHRONIC EXCEPTION

6. It is a wise and proper policy for a correspondent to cooperate with the institutional lender's national policy, and to avoid considering his organization and territory as a bona fide exception to that policy. I think that the national policies of most of the large institutional lenders have been carefully thought out by capable men; they at least deserve an open-minded trial from the correspondent. I do not advocate a slavish adherence to this principle; mistakes are made in the home office as well as in the field. Sometimes the adoption of a policy, generally wise from a national viewpoint, would result locally in harm to the institutional lender and it is then the correspondent's obligation to present the arguments against local adoption to his principal. In most cases, a variance of the mechanics can be effected without destroying the general policy. But the very natural tendency to argue that each particular territory should be an exception to this and that rule, regulation or procedure is one which should be curbed. Give the plan careful scrutiny with an open mind before you try to avoid its adoption. Don't get to be an habitual exception.

I said before that a fiduciary standard is, of necessity, a mutual proposition. For the home office viewpoint, therefore, corresponding and complementary courses of conduct are requisite. That home office which is in contractual relationship with a correspondent who believes in and practices an attitude of the greatest faith, possesses an asset. It can be retained only by reciprocity of conduct. The lender must trust his man. If he doesn't, the situation is hopeless since it is obviously impossible for a lending institution to do any volume of business in which trust and confidence play so important a part, except through men whose integrity is of the highest calibre. If correspondents are to feel that the protection of their principal is their first obligation, and if they demonstrate that idea in performance, they are entitled to the same confidence which that principal has in its employees. Correspondent and lender may occasionally clash in judgment, but they cannot doubt each other once. A loyal correspondent, therefore, is part and parcel of the institutional organization and not something extraneous to and distantly removed from it. His difficulties, including remuneration (if I may touch upon a very delicate subject) are the concern of the institution as well as his own. Over long periods of time, methods of payment may vary, earnings rise or fall, but I think the question of how and what should be a matter of some concern upon the part of the lender. Handling a mortgage portfolio involves two basic activities: *acquisition is the first, servicing is the second*. These two activities involve two separate sets of unrelated costs; origination of a mortgage costs money which is paid for by the borrower, or the lender, dependent upon whether the volume of money seeking this form of investment is much less than the market demands, or, conversely, greatly exceeds the demand. The servicing of a mortgage portfolio also costs money, and that cost, as far as I have ever been able to observe, is always at the cost of the lender. I also believe that any attempt to mix or mingle those two costs, or to insist upon the one providing the moneys to pay both will not on.y not succeed over a long period of time; but even if successful for a sufficiently long period to become a fixation in the minds of both parties, will eventually fail, disastrously for the correspondent, at great cost to the institutional lender.

MORTGAGES LIKE HORSES

I like to compare a mortgage to a horse: first you have to buy the horse; then you have to feed and care for him, and if you don't do both, you don't have a horse. Forms and methods may vary; names and appellations may change from time to time, but these two items of cost will be paid, at all times, by somebody. We tried it otherwise during the boom period of the twenties, and as long as the boom held, the system seemed feasib'e.

But it was only an apparent success. Hard times brought a cessation of new volume, accompanied by tremendously increased servicing costs. As a result, decimation of correspondencies through bankruptcy and failure followed, disastrous to the correspondent, very costly to the lender. I contend that the two items of cost are inherent in the business; and being so, are best frankly faced by both parties.

Here I tried to state the basic principles which should govern the business relationship between a correspondent and an institutional lender, and to illustrate those principles as a daily "working" idea by presenting what I conceive to be their impact upon some of the many phases of a correspondent's activities. I must confess that both the ideas and the illustrations have seemed to me so manifest as to require no statement.

WHAT THE PAPERS SAY

Not the sort of men to be content with giving their guests one side of the picture, the convention committee of the *Mortgage Bankers Association of America* supplied a pair of prophets for their meeting in New York.

Charles F. Palmer, co-ordinator of defense housing, told the convention that federal controls over industry will be relaxed after the war. Neither the government nor the people will try to continue priorities just for the fun of it, he said.

Virgil Jordan, president of the National Industrial Conference board, was less cheerful. He expects to see this nation go tearing into the war some time in the spring, invading Western Europe and burying the remains of our republic at the same time.

Maybe they're both wrong. Anyone whose memory goes back to 1932 is entitled to a few doubts about industry's ability to weather a new post-war hurricane without some encouragement and protection from the government, with the customary accompanying loss of independent for the protectee.

—*Editorial in the Duluth Herald*

The Most Desirable Type and Term of Loan for Office Buildings

Investigate location, construction, the management and net income—and in that order — in lending on office buildings

By HARRY C. PEIKER

I WISH I knew an infallible measuring rod—one which would take all the elements of risk out of a loan. Were I to devise one now and give it to you, there would then be no market for human judgment, and you and I and all the other high-priced mortgage loan executives would be on relief. In my twenty-five years of posing as a mortgage loan expert, I have listened to thousands of speeches on the subject and read tons of technical literature but I have never found a substitute for good common horse sense and sober judgment in analyzing and passing upon a loan.

There are many prime factors to be considered in determining the value of an office building from a lender's standpoint, but I will touch upon only a few of the major elements here. You can get the rest out of the text books prepared by the experts.

In my opinion the four most important factors are: Location, construction, management and net income.

There may be many others but I believe you will find most or all of them included in the above. For instance, location means not only the actual site, but is comprehensive of the needs and market for that particular structure and its competition with similar buildings in that locality. A survey should accompany every report on a loan to show the available office space, first in the immediate vicinity, and second, in the city as a whole, and the percentage of occupancy in that space. It should then be determined whether or not the rentals in the subject property compare favorably with rental space in similar buildings. An analysis of location should also reveal whether the building is the proper improvement for that particular plot of land, whether the size and shape of the lot warrants an office building or whether a one or two-story taxpayer might be a better investment.

I recently read an appraisal report rejecting a loan on a twelve-story office building placed on an irregularly shaped lot approximately 47 feet by 82 feet. The appraiser stated that a two-story commercial building would have been the correct improvement there, as too much space was lost with elevators, hallways, fire towers, etc., to show an adequate return from the present structure.

IN the May 1st issue, Mr. Peiker wrote What to Look for in Loaning on Office Buildings. This article is an expansion of some of the earlier points he made with some later reflections resulting from the rapidly changing conditions of today. He is associate superintendent of loans of the Massachusetts Mutual Life Insurance Company of Springfield.

An office building does not necessarily have to be on the 100 per cent business corner nor even on the best business street, but it should be close enough to attract a good lucrative ground floor tenancy, preferably retail stores and shops. An analysis of a number of ideally-located office buildings recently revealed the fact that the ground floor rentals averaged exactly twenty per cent of the total gross income and the maintenance expenses chargeable to the ground floor were less than five per cent of the total; hence the importance of location.

The second major element is construction, which includes not only the initial construction but also the daily upkeep and maintenance and periodic replacements and modernization. The building must be sound structurally, office space arranged desirably and flexibly, trimmed and decorated attractively and, most important, with provision for ample and permanent light and air. I say most important because I have seen the failure of several office buildings whose builders did not take the precaution to secure, either by purchase or agreement, sufficient light space from the adjoining property.

Management is the next major element in the successful office building operation and that includes servicing as well as renting space. I have seen many office buildings, ideally located and well constructed and designed, fail for lack of proper management. An owner sometimes will spend hundreds of thousands of dollars, sparing no expense in construction, and then all at once become penny-wise in his selection of the human machinery to make the project pay returns.

Good management of an office building is as essential to its success as is the management of a store, a factory, or a hotel. The manager must be capable of hiring and directing his service crew, must know how to purchase supplies, must be affable and courteous to tenants and must have the proper contacts to obtain a desirable tenancy. He must have enough finesse and diplomacy to shift smaller tenants from one space to another, as this is often necessary to accommodate the expanding needs of larger users.

The fourth major element, and, from a lender's standpoint, the most important, is income and expense, both present and potential—and don't take as gospel what is set down in the application. Very few applicants would willfully make misrepresentations but there are many items of expense (now and in the future) that are oftentimes overlooked. If the applicant cannot furnish you with certified audits of operations, then require your inspector to examine his books and statements. We recently analyzed the operating costs of a number of typical office buildings scattered in six different states and found the average annual cost of operation and maintenance (not including taxes and insurance) amounted to

sixty-five cents per square foot of rentable area. This may be a little high as I believe the Association of Building Owners and Managers state that the national average is fifty-six cents. One factor so often overlooked in the consideration of income and expense is obsolescence. There is a vast difference between depreciation and obsolescence. Depreciation means the normal wear and tear from usage. This can be minimized by constant repairs and replacements. Obsolescence means going out of style and failing to keep up with new models, and this is as true with office buildings as it is with automobiles. Time eternally marches on and each year your building is becoming a little more obsolete. With some buildings this factor is incurable. With others, which were flexibly designed and constructed, it can be minimized by proper allowance for modernization and reconditioning. I am speaking only of the structure itself. There is no cure for obsolescence of location and that is why I placed location first in the consideration of the four major elements.

NOW THE APPRAISAL

If you have considered these factors and many minor ones, included but not mentioned, you are now ready to set down an appraisal figure upon which to base the loan. In the old days we used to appraise the lot at what it cost or would bring, then add the cost of construction and base the amount of our loan on that figure. We now try to arrive, by various and sundry methods, at the economic value of the property and give due consideration to that value as well as the physical value. We know that many office buildings in the past were erected as monuments to the builder and are worth today economically a great deal less than they cost. Many of you have made loans in the past few years for an amount which was only a small percentage of the original bond issue. For loan purposes (and understand I am speaking strictly of values from a loaning standpoint) a property is worth what it will produce net, capitalized at a certain percentage. This percentage of capitalization varies in accordance with the location, the type and stability of tenancy, the nature and term of leases and the risk involved. After all there are many definitions of value and ten different appraisers may appraise a piece of property by ten different methods but they will probably all arrive at approximately the same figure in the end. In an address before the National Association of Insurance Commissioners, John G. Emery, Insurance Commissioner of Michigan, said there were thirty-five kinds of value and that they all boiled down to the definition given by an eminent national appraiser, namely, "value is the sum, stated in terms of legal tender, on which buyer and seller can agree when both are intelligent, well informed and not compelled to act." As I said before, the observations set forth here in regard to value are based entirely upon valuations for loan purposes.

NOW THE LOAN

Having arrived at what you think is the correct appraisal and decided to grant a loan for a certain amount, you are now ready to consider the terms of the loan. On this, there is no hard and fast rule to be followed but each loan must be considered on its own merits, based upon amount of loan, stability of returns and many other items. Every loan, unless it is for a very nominal amount, should have some principal amortization during its life. Most normal loans today are from 50 per cent to 65 per cent of the value of the property and such loans should provide for payments sufficient to liquidate the indebtedness in from 15 to 30 years, the time depending on a number of different factors.

Some lenders prefer a quarterly, semi-annual, or annual principal payment of a stipulated amount with the balance or so-called balloon payment at the end of the term. Personally, I prefer either a monthly or quarterly constant payment to include interest and principal, such payments being sufficient to liquidate the loan in the 15 to 30 year period. For example, a level constant payment of 7½ per cent per annum, payable quarterly (to include 4½ per cent interest) will reduce the principal 16.7 per cent in five years, 37.6 per cent in ten years, 63.7 per cent in fifteen years and completely amortize the loan in twenty years and six months.

No matter how thoroughly and completely you analyze a loan, no matter how many safeguards you throw around it in trying to make it risk-proof, you are going to end up with a sour one now and then. I recently heard a very appropriate story on this point.

Down South there was a negro preacher who had heard of the great financial success that Billy Sunday had made in his evangelical efforts, and thinking to emulate him, he got a tent and gathered together a gullible and perspiring negro congregation. Then he arose and addressed them as follows:

LAGNIAPPE

"Brothers and sisters, I am here to save Memphis, and when I gets through with Memphis I'll run over and save Mobile. Yes, sir, save Memphis and save Mobile. But first I want to tell you all what kind of a man the devil is.

"Now you can take a stake and drive it in the ground and take ropes and wrap them around the stake, wrap them around the devil's ankles, and around his knees, but the devil will get you just the same. And you can even take a steel stake and drive it into the ground and take steel chains and wrap them around the devil's knees, around his waist, and, brothers and sisters, the devil will get you just the same.

"And you can even sink that stake in concrete, tight in concrete, and take them steel chains, and twine them around the devil's shoulders, cross-hitch 'em, double-hitch 'em, and tie 'em around his neck, but brothers and sisters, I'm here to tell you the devil will get you just the same."

At this point a little negro in the front row, with his eyes nearly popping out with fright, jumped up and said: "My God, he might just as well be loose."

DETROIT MBA VOTES CONSTITUTION CHANGES

The Detroit MBA has voted several changes in its constitution, the most important of which concerns admission to the organization. Under the amendment new members must be referred to the membership committee with complete supporting data. The names must then be referred to the Board of Governors where an affirmative vote of seven members qualifies for election.

The second change provides that annual dues may not be more than $25 and all members in arrears for ninety days shall be subject to expulsion by a majority vote of the Board of Governors.

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SO THEY TELL US

One man's experience: "One of our local lenders had an FHA loan on his books and the borrower came in and said: 'Mr. So-and-so (one of our competitors) has offered to refinance my loan at no charge and give me $60 besides. What will *you* do?' The lender said: 'Well, *I* will reduce your rate and give *you* $60.' He forgot to make that for a definite period of time and did plenty of worrying for fear the fellow would come back next month and get $60 more. It actually happened—he gave the man $60 and reduced the rate."

Belatedly reporting an earful at the New York Convention: *Young thing*: "But he seems so young to be in the mortgage business." *Mortgage man*: "Yes, but he only makes junior mortgages."

Mountaineer: "Doc, I want you to look at my son-in-law. I shot at him yesterday and took a piece out of his ear."

Doctor: "Shame on you, shooting at your son-in-law."

Mountaineer: "Huh. He wasn't my son-in-law when I shot him."

WM. B. F. HALL'S ARTICLE

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be judged so much upon the quantity as upon the quality and ultimate profit in the loan portfolio which he produces and services.

With such a correspondent, the relationship with the institutional investor, except for the percentage form of compensation, is very similar to that of a direct company representative. To such a correspondent the institutional investor owes the same confidence of a continuing and permanent relationship that is enjoyed by its most trusted home office employee. It owes its correspondent the prestige and protection of exclusive territorial representation and will refer home office business leads to him just as surely as if he were on the pay roll of the company.

Neither of these extremes of mixture is necessarily good nor bad. Between them lies an infinite number of combinations of *independent operator* and *direct representative*, no one of which can be called the one and only right one. Each team must devise its own mixture, its own level of *broker-branch office operation*, and apply it with equal strength and fairness to both parties.

It must be remembered, however, that in determining this mixture, full consideration must be given to the independent nature of the correspondent's business and to the commission form of compensation both on the acquisition of new business and the servicing of it. It must be recognized that mortgage lending is inherently and inseparably a part of a very broad real estate field from which institutional investors and especially life companies are restricted from doing business.

One of the greatest inherent advantages of the correspondent system is that, as an independent business man, a correspondent may participate in the ownership and profit inherent in, and closely allied with, the real estate field. As an example, in the development of a single piece of business real estate, there is open to any correspondent equipped to handle it, and entirely apart from the mortgage business, a profit in the sale of the land, the negotiation of the leases, the sale of the completed property, the writing of the hazard insurance, and the management of the property itself. In none of these may the lender's direct representative participate.

Another inherent advantage of the independent operator is that unless the institutional investor is large and makes all types of loans, the correspondent has an advantage in representing more than one outlet.

In this way, he serves his borrowing public with every type of mortgage loan, although one of his principals may prefer apartments, another residences, and a third retail commercial security. Here again the direct representative must limit himself to the amounts and types of loans desired by one employer, and this in itself is likely to limit his operations to a degree where overhead becomes excessive.

The third advantage of the independent correspondent is the enjoyment of the combined advantages of little and big business. As big business, the principal can make available to him the advantages of its extensive legal department, its advertising and publicity experts, its trained accountants, and the prestige of its nationally known name. Yet, as typical of the advantages of little business, this correspondent incurs, audits, and approves his own expense accounts. No layers of management superimposed upon layers of management tend to bog down his speed of operation nor obscure his clear-cut pictures of his own problems and their solution. All of these three advantages of the correspondent as an independent operator must be clearly appreciated and fully respected by his principal.

Entirely too much discussion and negotiation has been had upon the gross commission schedules which principals pay correspondents for making and servicing mortgages; little or no consideration has been given to improving his net income, which is the thing that really determines whether he ends up in the red or black after deducting his operating expenses.

Often a large institutional investor requires of its correspondents cumbersome and specialized accounting, reporting and office procedure on the grounds that it must have inflexible uniformity from all of its correspondents in all parts of the country. Too much of this has already been done by the investor and too little study has been given such questions from the standpoint of the team itself. To cut infinitesimal amounts from the office expense of the investor, and at the same time radically increase the expenses of its entire correspondent organization, is shortsighted policy indeed; in the long run, the profits and expenses of the mortgage business cannot be passed back and forth between correspondent and principal. The interest of the correspondent and principal are one and the same, and not until their common purpose and interest is fully recognized can the inherent relationship between them be fully understood, nor will the full potential profits of the mortgage business to each one of them be fully realized.

T. S. Burnett Warns Lenders to Watch Inflationary Trends

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figure has been distorted by the defense program in all of its various aspects.

I think we are not justified in recognizing increased costs, to such extent as it may be determined that a fair and representative cost of construction has been increased by the present emergency.

The ratio of costs to benefits and ability to pay over a period of years is the real measure to apply and must be based on normal conditions of employment, wages, and the cost of living for the population groups that make up our customers.

COSTS EXCESSIVE

Building costs in abnormal times such as today, when the country has called upon business to produce more and faster than ever before, are undoubtedly excessive and cannot be accepted as a criterion in the determination of basic values. In support of this conclusion I have these comments to make:

In our "all out" production for defense, SPEED not economy is emphasized.

Competition of "defense housing" with private building, with contractors attempting to make purchases of, or get protection for, 100, 200 or 300 houses has thrown normal supply and demand factors out of balance and played havoc with distribution.

Contractor's "pack" or "cushion", due to fear of priorities, is large today.

Hoarding by large operative builders and material houses is in evidence.

Delays and decreases in efficiency of labor are encountered.

Change from water to rail shipping has increased the price of lumber.

Bidding for materials, of which there is temporarily a scant supply, is prevalent.

Defense construction, not defense production—may be at a peak.

There is evidence that construction standards and specifications are being relaxed.

Are there any of us who do not feel instinctively that a settling down process will inevitably come with a return to the operation of more normal factors of supply and demand?

Much is said of our inherent responsibility to cooperate with the defense program in the housing field. I will not touch on this subject here except to say that the way is provided under FHA where the risk is spread and a protective ceiling has been placed on our losses.

Under conditions of war boom which now exist, the *market risk* in mortgage lending is probably greater than at any time since the present upswing began and will be intensified as we go ahead with the defense program. If we follow up on costs or relax standards and specifications, which is doing exactly that, we are going to accumulate loans at present or higher costs where there is every probability equity will disappear. In the housing field, for example, no reliable estimate can be made as to the extent of the over-supply which will undoubtedly exist in some areas at the expiration of the defense emergency. The situation will depend upon the ability of defense plants to convert their production capacities to peacetime operations and upon population shifts to and from the area following the end of war. If employment does recede materially, and instinctively we all feel it will, and as a result we have wholesale foreclosure of loans, our conventional loans are going to have to compete both market and rental-wise with a tremendous number of distressed properties offered for sale.

AN OLD SUSPICION

In this reference I do not mean only FHA Title VI loans—approximately 85 percent of Title II's are in defense areas and most of the substantial cities in the country have been so designated.

Cessation of defense work, with shifting of labor away from defense areas, promises to take its toll on all classes of properties—business, residence and residential income—in varying degree. Water seeks its own level. Equities will disappear as against market value of other properties offered for sale. Moratorium and relief legislation has already or will dispel, to all practical purposes, the ability to recover deficiency judgments and we may be faced with serious losses.

I have long suspected that there is no margin of profit in a mortgage portfolio over and above a normal interest return. There may be a profit on book figures or cost of acquisition of real estate, but if it were possible, through intelligent cost accounting, to apply the hidden and intangible losses in the way of excessive servicing costs and loss of income on poor loans against individual cases where it was believed a profit was realized, that profit would usually disappear. Certainly there is not enough chance of profit at present rates and earnings among institutional investors to expose mortgage loans to excessive building costs and the probable losses which may result.

Let's all remember we are dealing in futures. We must think, be virile, vigilant. We cannot place too much emphasis on that word *think* in its application to the mortgage business. It must be emphasized just as much in generality as the factor of location in lending is emphasized specifically. If, by the exercise of sound judgment and prudent selectivity, we can minimize losses and, through continuity in our mortgage operations, achieve a satisfactory average rate of interest over a period of years, either for ourselves or our clients, is that not the program to follow for all of us whether we be institutional investor or mortgage banker?

HITS RENT CONTROL

The Chicago MBA has spoken out on proposed national legislation designed to control rents. The Association, through its president, Ralph A. Hunt, questions the soundness of principles. Hunt declared:

"The rent control legislation now under consideration provides for a control of the gross rent, but does not protect the owner of the property by controlling all of the costs of operating his property or local rates of taxation."

Although proposed legislation specifically states that in no wise is it intended to control wage levels, Mr. Hunt points out that a major portion of the costs in the operation and maintenance of a property is the cost of wages.

Lending institutions in Chicago report ample funds available for new construction at the lowest interest rates which have been known in this part of the country, according to Mr. Hunt. "These funds," he declared, "could be put to work and new, modern, attractive housing facilities."